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**During the past 20 years the reputation of central banks has expanded far beyond their true stature and accomplishments. The heads of the most prestigious banks have been placed on lofty pedestals, from which descent can only be abrupt and painful. Paul Volcker, a worthy candidate for the epithet of giant, left while the going was good. Alan Greenspan, while highly regarded in financial circles, must live in daily dread of the global financial catastrophe that will shatter his reputation.**

***Debt and Delusion*, Peter Warburton**
**Allen Lane, The Penguin Press, 1999**

## FRAUD EXPOSED

Opinions and expectations about the U.S. economy are changing for the worse; however, they are changing very grudgingly. Initially, the downturn was regarded as a mere inventory correction that would turn around rapidly in this year's second half. That half has meanwhile arrived, but the economic data show an economy that continues to weaken. With corporate profits and capital spending in their steepest slide in decades, there is no hope for an imminent economic recovery. Nevertheless, the consensus remains united in the conviction that it is only a matter of time before the Fed rate cuts and the government's tax rebates will turn the economy around. For some time there seemed to be rather more pessimism about Europe than about the United States.

We have read many forecasts, all of them more or less optimistic. The simplistic, basic assumption behind them all is that the rampant money creation of the recent past is bound to kick-start the U.S. economy. Most economists have yet to understand that the dynamics of this economic downturn in the United States are fundamentally different from the inventory-driven recessions of the past. This one is about a profit depression fueling an unprecedented collapse in business capital spending, which, in turn, ravages employment and consumer income.

Still, there is no doom and gloom about the U.S. economy. Years of new era propaganda have struck deep roots in people's mindset. While Fed Chairman Alan Greenspan essentially has to admit that *"the risks are weighted mainly toward conditions that may generate economic weakness,"* he keeps emphasizing that *"long-term prospects for productivity growth and the economy remain favorable."* And most people readily believe him.

In our view, this is the great delusion. Due to the unbelievable borrowing and spending excesses of the past few years, the U.S. economy is now much weaker and much more vulnerable than is generally being realized. Collapsing profits and business capital spending are leading the downturn. What's more, a statistical benchmark revision by the Commerce Department, covering the period since 1997, has slashed the figures for the growth of GDP, productivity and business profits with such vehemence that it condemns the economic miracles of the past few years to oblivion. Strikingly, these drastic downward revisions have found very little resonance.

Closely tied to the economy's future performance are, of course, the prospects for the dollar. The reasons why it should weaken, at least against the euro, are well known. The obvious catalyst for its sudden, sharp downturn against the euro is the growing realization that the economy's and the stock market's poor performance will last longer than expected. In this situation, two concerns about the U.S. economy and the dollar have become paramount: *first*, the duration and severity of the economy's weakness; and *second*, the fate of the dollar — will it be an orderly correction or free fall?

American and European policymakers are united in the hope and desire that the dollar will do them the favor of a measured downward correction against the euro. We do not think this outcome has the slightest chance. At the very least, it ought to be realized that the risks of a free-falling dollar are immense. With a stagnant economy, a shaky stock market and a monstrous trade deficit, the slightest sign of a major downturn of the dollar could send foreign investors and speculators stampeding for the exit. Over the years, claim after claim about a "new paradigm economy" in the United States has been exposed as false: the notion that the business cycle was obsolete; that spending on information technology was recession-proof; that classical methods of stock valuations were henceforth irrelevant; and so forth. Using more complete government data, chiefly from final corporate and individual tax returns, the Commerce Department has recently published revisions to a host of economic data that virtually demolish the two main pillars of the New Economy: the productivity and the profits miracle. Considering the enormous difference between mediocre reality and trumpeted myth, we think it was rather more than a misconception. There was systematic fraud.

## TIGHT PROFITS, NOT TIGHT MONEY

Does Mr. Greenspan, or the great majority of Wall Street pundits for that matter, really have a clue of what the moving force behind the U.S. economy's sudden, sharp slump is? The generally accepted explanation is tight money and credit. Never mind that actual figures show record-sized flows of both of them. The most obvious chief cause is a profit carnage of unprecedented severity fueling an unprecedented carnage of business capital spending. The ultimate aim of all production and of all capital spending in the capitalist economy is the pursuit of profits. Remember Keynes' quote that we have cited before: *"The margin which the businessman requires as his necessary incentive to produce may be a very small proportion of the total value of product. But take this away from him and the whole process stops."* Normally and essentially, a weakening economy implies weakening profits. But what is presently happening to business profits in the United States vastly exceeds the normal, cyclical pattern.

How does Mr. Greenspan explain the economy's sudden plunge? It was in a congressional testimony in late January that he spun the tale of two different kinds of recession — the garden-variety inventory adjustment and the more serious economic downturn fuelled by what he called a "breach of confidence." In blatant disregard of contrary statistical evidence, he argued that the United States was experiencing the first and benign version of the two types of contraction, and left no doubt about his intention to do everything in his power to contain the damage and to prevent this downturn from cascading into a full-blown collapse in confidence. There can be no mistaking his view and his aim: It is all about maintaining confidence.

## THE TRUE PROBLEM: EXCESS OF CONFIDENCE

Is it really? We vehemently disagree. Of course, psychology and confidence matter most importantly. Still, stating this needs a distinct qualification. What an economy needs to stay in healthy condition is reasonable confidence, reasonable in relation to underlying growth fundamentals.

***But what was built up in the United States during the past few years was grossly unreasonable confidence in non-existing "new paradigm" miracles. What Wall Street and others systematically created was rather a form of collective, manic euphoria, apparently justifying sky-high stock valuations. After all, there has been overconfidence for so long that most people simply cannot conceive of a possible recession and a prolonged bear market.***

America's greatest problem is not a lack of confidence but the exact opposite: An unrealistic and unsustainable excess of expectations in future prosperity that was built up in the past boom years. For good reasons, Mr. Greenspan is frightful that this confidence is going to break one day. It is actually a historic fact that overconfidence is the regular precursor of the most serious economic downturns. Manifestly, it's the necessary condition that fuels the unsustainable excesses in borrowing and spending. On the face of it,

overpowering confidence still seems to be the U.S. economy's greatest strength. The irony is that once it breaks, it will turn into the economy's greatest vulnerability.

It is a widespread perception that profits primarily drive stock prices. For many people, therefore, the surge of U.S. stock prices during the past few years essentially reflected soaring corporate earnings. Wonders of productivity and profit growth, due to the new information technology and a managerial revolution, became a key article of faith in the U.S. New Economy. With the benefit of hindsight, including recent drastic downward revisions of the GDP, productivity and profit aggregates, it is now clear that U.S. stocks skyrocketed in the late 1990s against the backdrop of barely stagnating corporate profits.

Earnings of nonfinancial corporations, measured by the National Income and Product Accounts, effectively fell from $463.3 billion to $448 billion between 1996 and the fourth quarter of 2000, marking a decline by 3.3%. Over the same time, stock prices soared skyward. When hitting its peak in January 2000, the Dow was up 52.7%. The S&P 500 peaked in March 2000 after a gain since end-1996 by 105.8%; also at its top in late March 2000, the Nasdaq had gained 284% in comparison to its level at end-1996.

According to surveys, bullish sentiment among the American public about the stock market remains around record levels. It definitely was not lack of confidence that caused last year's crash, and neither is it obviously lack of confidence that is preventing the bull market's quick return. It crashed and the economy weakened regardless of high-riding confidence. Mr. Greenspan appears desirous to suggest that his excellent policy may be thwarted by unfounded changes in confidence of the public. To quote Schumpeter on the subject: *"No great crisis has ever come about that was not fully explainable by the objective facts of the situation. Expectations not so conditioned never have produced more than short-lived spurts or breaks. And this is true not only for general business situations but for any particular market."*

In other words, such a sharp and broad-based economic downturn is, essentially, driven by deeper economic or financial causes. For most American economists there is but one possible explanation. Mr. Greenspan's rate hikes in 1999 and 2000. Considering, however, that money and credit expansion has never slowed but instead has constantly continued at record rates, this explanation simply makes no sense. It seems to us unquestionable that the U.S. economy's downturn has a variety of causes arising from the excesses and imbalances that have accumulated during the boom years. Nevertheless, we would emphasize one particular cause as most important, and that's the unprecedented profit carnage.

## WHAT KIND OF DOWNTURN?

Slowly but steadily recognition is spreading that the economic downturn presently unfolding in the United States is radically different from anything previously experienced in the whole postwar period. While the dreadful profit news is haunting the stock market, it finds very little or no attention in the macroeconomic discussion. It remains narrowly mired on just two points: a request to the Fed to cut interest rates further, and expressions of hope that the consumer may keep up his borrowing and spending binge. Beyond that there is complete silence and flat denial.

Manifestly, the speed and breadth of the U.S. economy's downturn that started in last year's third quarter has taken both policymakers and the consensus completely by surprise. Although it is generally recognized and accepted that its primary propellant is an unusually steep decline in business capital spending, this doesn't prevent Mr. Greenspan and the bullish Wall Street consensus from placing great emphasis on the inventory cycle.

As Mr. Greenspan said in his congressional testimony on July 18, 2001, *"At some point, inventory liquidation will come to an end, and its termination will spur production and incomes. Of course, the timing and force with which that process of recovery plays out will depend on the behavior of final demand… Despite evidence that expected long-term rates of return on the newer technologies remain high, growth of* ***investment*** *in equipment and software has turned decidedly negative…"*

And here's how he ended this congressional testimony: *"As for the years beyond this horizon, there is still, in my judgment, ample evidence that we are experiencing only a* ***pause*** *in the investment in a broad set of innovations that has elevated the underlying growth in productivity to a rate significantly above that of the two decades preceding 1995."* Plainly, Mr. Greenspan is not worrying about deeper causes behind the collapse in capital spending that might drag it down for a prolonged period. Rather, he sticks to his familiar gospel of the U.S. economy's new paradigm qualities that make a serious, prolonged economic downturn virtually impossible.

Under the headline "Greenspan Puts Us on the Couch," Robert J. Samuelson wrote recently in *Newsweek: "He's trying to temper the slowdown by talking up the U.S. economy's long-term prospects. The curiosity of this economic slowdown is that Federal Reserve chairman Alan Greenspan as national therapist seems absurd, and yet it's true. For roughly 18 months he has engaged in the quiet exercise of confidence building. Even as he has raised interest rates (in 1999 and 2000) to pre-empt inflation and cut them (this year) to prevent recession, he has consistently laced his speeches and congressional testimony with glowing appraisals of new technologies and the country's long-term prospects."*

While the bad news about the U.S. economy has been swelling to a torrent, the stock market, carefully guided by Wall Street pundits, has nevertheless held up remarkably well. A few bits of somewhat better looking news attract all the attention. The one topic that everybody likes is the U.S. economy's impending recovery. We have always marveled at the capability of Wall Street pundits to ignore bad news or to dress it up as good news, yet what's lately happening in this respect is more impressive than usual.

In late July, the Department of Commerce published benchmark revisions concerning GDP, productivity and profits for the years 1998-2000. At the very least, the numbers badly dented the alleged New Economy miracles of the past few years. In our view, they effectively demolished them. Worst hit was the year 2000. GDP growth in that year lost 0.9 percentage points, from 5% to 4.1%. From fourth quarter to fourth quarter, it was revised down from 3.8% to 2.5%. Productivity growth came down 1.3 percentage points, from 4.3% to 3%. As for business profits, the formerly trumpeted profits miracle now looks more like a profits crisis. Considering it the most important depressive influence on the U.S. economy, the profits disaster will occupy us in greater detail later in this letter

Let us first have a look at the changes in GDP. Here, too, publicity and reality show remarkable differences. Above all, the perception of a very resilient consumer requires significant qualifications. His spending appears strong when compared with the collapse of business capital spending. Still it has drastically slowed. Its growth rate has practically halved against a year ago. Assessing the overall development, it strikes us that the private sector is already in recession. Only a jump in government spending — see the bottom right of the table — has kept GDP growth out of negative territory.

**CONTRIBUTIONS TO PERCENT CHANGE IN REAL GROSS DOMESTIC PRODUCT**
**(Seasonally adjusted at annual rates)**

| | 2000 | | | | 2001 | |
|---|---|---|---|---|---|---|
| | I | II | III | IV | I | II |
| **Gross Domestic Product** | | | | | | |
| **Personal Consumption** | 3.94 | 2.50 | 2.88 | 2.14 | 2.05 | 1.44 |
| **Fixed investment** | 2.24 | 1.49 | 0.44 | 0.09 | 0.33 | -1.55 |
| **Nonresidential** | 1.88 | 1.52 | 0.91 | 0.13 | -0.02 | -1.86 |
| **Structures** | 0.26 | 0.35 | 0.45 | 0.24 | 0.39 | -0.40 |
| **Equipment** | 1.63 | 1.17 | 0.46 | -0.11 | -0.41 | -1.45 |
| **Residential** | 0.36 | -0.03 | -0.47 | -0.05 | 0.35 | 0.31 |
| **Net Exports** | -1.32 | -0.84 | -0.70 | -0.39 | 0.63 | 0.14 |
| **Government** | -0.20 | 0.78 | -0.32 | 0.58 | 0.92 | 0.95 |

*Source: Department of Commerce, Survey of Current Business*

## GREENSPAN BULL SPIN

Back to Mr. Greenspan. Of course, this is not the first time that he has said things that are most unconventional for a central banker. Not only has he accommodated the worst asset bubble in history, he has celebrated it. Years ago, he readily, if not eagerly, adopted the role of America's most prominent and also most presumptuous New Era Apostle, and in hindsight it is fair to say that he has outdone everybody on Wall Street in spreading bullishness about unprecedented technological and managerial wonders happening to the U.S. economy.

Time and again, his public speeches and congressional testimonies have contained statements that were unambiguously prone to stoke euphoric expectations about future income and profit growth, implicitly endorsing the unprecedented levels of stock valuations. Among the most shocking examples of such speeches was one in which he explained that the unprecedented stock valuations might be the appropriate response to the dramatic advance in information availability, thereby reducing uncertainty and therefore risk premiums.

To quote him: *"The rise in the availability of real-time information has reduced the uncertainties and thereby lowered the variances that we employ to guide portfolio decisions. At least part of the observed fall in equity premiums in our economy over the past years does not appear to be the result of ephemeral changes in perception. It is presumably the result of a permanent technology-driven increase in information availability, which by definition reduces uncertainty and therefore risk premiums. This decline is most evident in equity risk premiums… According to this argument, much, possibly all, of the decline in equity premiums over the last five years reflects this learning process. It would be a mistake to dismiss such notions out of hand. We have learned to no longer cower at an eclipse of the sun or to run for cover at the sight of a newfangled automobile."*

So, for Greenspan, the unprecedented stock valuations were the appropriate response to the dramatic advance in information technology. Understandably, the bulls admired and loved him for helping them not only with unprecedented money and credit creation, but also with such unprecedented pep talk.

Virtually all his speeches were interlarded with remarks that manifestly supported the stock market's bull run. Still, some speeches were worse than others in this respect. Another one that particularly shocked us was a speech to international central bankers in 1999. One of its topics was U.S. business profits. His starting point was that the *"shift in the composition of gross domestic product toward idea-based value added is muddling our measures of current earnings and, hence, our projection of future earnings. The key definitional question that must be confronted is: What is capital outlay? What is an expense?"* He left no doubt that, in his view, many more outlays ought to be capitalized; *"There is even an argument for capitalizing new ideas, such as different ways of organizing production that enhance the value of a firm without any associated outlay."*

While admitting that, for example, the use of stock options and the reduction of corporate contributions to pension funds through rising stock prices have augmented reported profits, he concluded, however: *"Nonetheless, it is reasonable to surmise that undercapitalized expenses have been rising sufficiently faster than reported earnings to have more than offset the factors that have temporarily augmented reported earnings."*

Late in 1999, by the way, America's Securities and Exchange Commission gathered some people together to look into how accountants might get better at revealing "value in the New Economy." According to a report we read: *"The problem with all of this is that nobody inside the accounting profession has any idea of how to put a numerical value on internally generated intangible assets, at least not while staying true to the principle of reliability."* However, the main purpose of the exercise is all too clear: to provide an unlimited scope for profit manipulation.

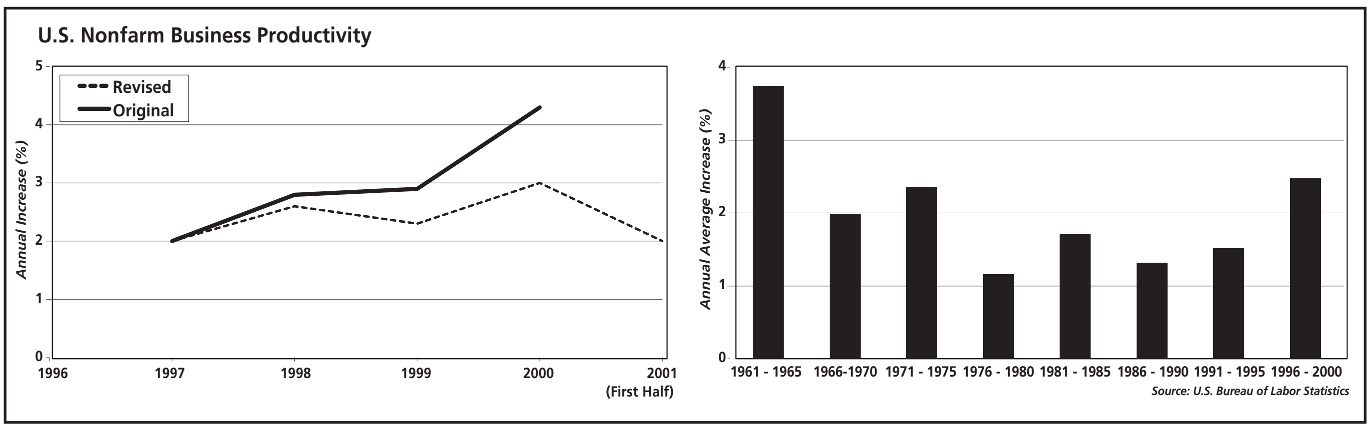
For sure, psychology matters. Most people, we presume, regard Mr. Greenspan's current efforts in confidence building by stressing the U.S. economy's excellent long-term prospects as a reasonable and

legitimate exercise for a policymaker. We do not agree. There are some unwritten rules about what central bankers may say in public and what they may not. Good tradition has it that they should not try to influence the markets. In his speeches in the past few years, Greenspan went to extremes as a cheerleader of the bull market, and now in the bear market his talking comes close to moral hazard. Such talk from the man most listened to by investors implicitly tends to create false hopes and to lure people into the stock market. Actually, we think this is precisely what Mr. Greenspan has in mind.

## BOGUS PRODUCTIVITY MIRACLE…

The most important, single myth behind the U.S. stock market bubble was that the technological and managerial revolution transformed the U.S. economy so profoundly that everything is vastly different this time: the measures of stock valuation, profit prospects, low inflation and high employment. The lifeblood of all claims about a new paradigm economy was the contention of a productivity miracle.

Sharply rising rates of productivity growth in the past few years were wildly celebrated as compelling proof of the super-efficient New Economy in America. Here, too, the recent statistical revisions have drastically changed the picture. According to the old figures, annual productivity growth had averaged 3.4% in 1999-2000. That has now been shaved to 2.6%. Mr. Greenspan had placed great weight on the fact that productivity growth had accelerated to 4.3% in 2000 and expressed his belief that, after stripping out the cyclical impact of the economic boom, this would suggest around 3% structural productivity growth per year. Over the past five years, average productivity growth has been trimmed to 2.5% from 2.8%. Taking into account that some of this was "cyclical," annual long-term productivity growth appears to be now around 2%, as against a former rate of 1.5% between 1973-1995.




But if you take furthermore the artificial additions to real GDP growth — and thereby also to productivity growth — through the use of hedonic price indexing for the output of computers into account, there is every reason to wonder whether there has been any improvement in the economy's overall productivity.

A few weeks ago, it made headlines in the media that America's productivity growth had "surged" in the second quarter. It was hailed as proof that the New Economy still exists. The surge was an increase from an upward revised growth of 0.1% (annualized) in the first quarter to 2.5% (annualized) in the second quarter. These quarterly figures are notoriously volatile. Actually, growth in productivity had slowed, year-over-year, from 2.5% in the first quarter to just 1.6% in the second quarter.

## …AND BOGUS PROFIT MIRACLE

Now to the fabled profit miracle. In order to understand the degree of delusion that has taken place about U.S. corporate profit performance during the last few years, it is necessary to distinguish between three different

measures: *first,* market perception and expectations of current and future corporate earnings growth as created by Wall Street propaganda; *second,* S&P 500 earnings per share as reported by the individual companies; and *third,* NIPA profits, that is, profits computed by the national income and product accounts.

As to the first measure, we think it is fair to say that Wall Street propaganda managed to implant into the markets the perception and expectation that corporate profits were rising at rates high up in the double-digits, close to 20% per year, and that this profit miracle would last for many years to come. It goes without saying that these implanted, exuberant profit expectations during these years played a crucial role in catapulting American share prices into the sky.

It has been another familiar theme of this letter that the claimed Great Profit Miracle was flatly inconsistent with the profit figures as shown in the official NIPA numbers. What these plainly suggested was a mediocre profit performance at best. It has always been common knowledge that companies and their CEOs were increasingly hyping their reported profits, in particular the earnings per share, with many kinds of gimmicks to deliver the continually rising sales and earnings that Wall Street wants to see, thus enabling brokers and the investment banks to keep up their bullish mantra. This obvious great deceit worked beautifully for years.

To our great astonishment, we learn from a report in the Commerce Department's Survey of Current Business that even these heavily manipulated reported profits, looked at in the aggregate, make nevertheless pretty bad reading. The following figures, comparing NIPA and reported S&P profits, are from this report. Please note that NIPA profits in 1997 and 1998 were also heavily bolstered by soaring capital gains.

The shocking reality of the booming U.S. new paradigm economy was an unusually poor profit performance. But how was this Great Profit Deceit possible? Wall Street simply developed another gimmick to mask the truth and to mislead investors. It invented the comparison with *expected* profits that could be arbitrarily lowered to levels that allow favorable comparisons of newly reported profits. The fact is that many people effectively knew of this systematic deceit of investors. Yet nobody in responsible positions took issue.

**COMPARISON OF SELECTED MEASURES OF PROFITS**

| | 1995 | 1996 | 1997 | 1998 |
|---|---|---|---|---|
| ***Billions of Dollars:*** | | | | |
| **NIPA profits before tax** | 668.5 | 726.3 | 792.4 | 758.2 |
| **Less: bad debt expense** | 67.8 | 74.7 | 83.6 | 88.3 |
| **Plus: capital gains** | 115.5 | 132.9 | 200.5 | 206.3 |
| **Equals: adjusted NIPA profits** | 716.2 | 784.5 | 909.3 | 875.2 |
| ***Percent change from preceding* year:** | | | | |
| **S&P reported earnings:** | | | | |
| **Earnings per share** | 11.0 | 14.0 | 2.6 | -5.1 |
| **Earnings** | 13.2 | 17.0 | 4 | -2.2 |
| **NIPA profits before tax** | 16.6 | 8.7 | 9.1 | -4.3 |
| **NIPA profits after tax** | 18.3 | 9.9 | 10.4 | -7.5 |

*Source: Survey of Current Business, April 2001*

But now comes the sledgehammer. As bad as those numbers are, the Commerce Department has recently published revisions for the period since 1997 that slash the NIPA profits further. What's left is the U.S. economy's poorest profit performance during boom years in the whole postwar period. According to the old figures, nonfinancial profits between 1996-2000 rose from $463.3 billion to $577.9 billion, or 24.7%. The new figures show, instead, a decline by 3.3% from $463.3 billion to $448 billion. As a share of national income, profits are down dramatically over this period, from 12% to just 8%.

The table below presents the old and the new revised figures. The worst hit is the manufacturing sector, showing a virtual profit collapse since 1997 by more than 50%. The biggest losers within the sector were producers of durable goods and of electronics and other electric equipment.

Take a close and critical look at these figures. These are revisions of breathtaking size. Measured by the old figures, the profit performance of U.S. corporations over the 1996-2000 period appears mediocre at best. Measured by the new, revised, figures, it is wretched.

**UNITED STATES: CORPORATE PROFITS (IN $BILLION)**

| | 1996 | 1997 | 1998 | 1999 | 2000 | Q4 2000 | Q1 2001 |
|---|---|---|---|---|---|---|---|
| *Old numbers* | | | | | | | |
| Domestic Industries | 628.6 | 690.2 | 711.5 | 744.6 | 805.0 | 755.3 | 739.4 |
| Financial | 165.3 | 185.7 | 164.8 | 172.0 | 193.6 | 198.9 | 198.5 |
| Nonfinancial | 463.3 | 504.5 | 506.8 | 530.4 | 577.9 | 527.3 | 497.1 |
| Manufacturing | 181.2 | 195.2 | 177.4 | 181.6 | 185.0 | 152.4 | 131.6 |
| Durable goods | 87.0 | 94.0 | 85.4 | 92.2 | 89.0 | 71.8 | 59.3 |
| Electronics | 20.2 | 22.8 | 10.6 | 12.3 | 14.1 | 10.8 | 6.4 |
| Retail Trade | 52.9 | 63.9 | 76.6 | 81.5 | 89.5 | 83.5 | 91.8 |
| Transportation & Utilities | 91.4 | 85.0 | 83.9 | 88.4 | 100.8 | 94.3 | 92.1 |
| *Revised numbers* | | | | | | | |
| Domestic Industries | | 690.2 | 637.2 | 658.8 | 696.3 | 652.4 | 613.8 |
| Financial | | 187.5 | 158.4 | 191.0 | 204.5 | 204.4 | 202.2 |
| Nonfinancial | | 504.5 | 478.8 | 467.8 | 491.8 | 448.0 | 411.6 |
| Manufacturing | | 195.2 | 164.3 | 163.7 | 155.2 | 119.4 | 90.4 |
| Durable goods | | 94.0 | 80.7 | 75.8 | 63.2 | 38.1 | 24.8 |
| Electronics | | 22.8 | 7.6 | 6.2 | 3.2 | 0.8 | -1.5 |
| Retail Trade | | 63.9 | 73.8 | 77.1 | 81.8 | 76.3 | 84.9 |
| Transportation & Utilities | | 85.0 | 79.1 | 59.0 | 67.4 | 67.3 | 66.4 |

*Source: U.S. Department of Commerce, Survey of Current Business*

What's behind this massive downward revision of profits? The substantial downward revision to productivity growth was a major factor; a substantial upward revision to wage and salary income by $61.5 billion, largely resulting from larger than anticipated stock options bonuses, was another. Both were due to the prior boom in high-tech IPOs and merger and acquisition activity. Substantially higher wage costs and lower productivity growth essentially translate into substantially lower profits. All things being equal, this income-booster of 2000 will become the income-depressant of 2001.

***We have always strongly contested the trumpeted American profit miracle. Yet we were not prepared for these new, sharply lowered figures. According to the old figures, it was a barely mediocre profits performance. The new figures expose the former, alleged profit miracle as an outright profits disaster. Considering furthermore that this dismal profit performance covers years during which the U.S. economy has been booming, it definitely raises alarming questions about underlying corporate profitability, both of the New and the Old Economy. Further consider that even these poor profit numbers have been heavily flattered by capital gains in the stock market.***

## WORSE TO COME

For the time being, everybody remains in blunt denial of the miserable profit facts. One of the quixotic results is that price-to-earnings ratios have risen to their highest levels ever because profits have fallen even faster than stock prices. There is but one explanation for this absurdity: a sustained, general denial that the U.S. economy is in deep trouble. Hope and expectations that a virulent recovery is only a question of time remain deeply rooted.

Yet the warning signs that the Fed's aggressive easing is definitely failing to spark a recovery are strikingly obvious. Broadly speaking, easy money essentially works through easing the financial markets: *first,* by reducing long-term interest rates, on which most borrowing is based; *second*, by boosting equity values, thus raising consumer wealth and lowering corporations' costs of equity financing; *third,* by lowering the value of the dollar, which helps U.S. exports.

In the past, these effects have always promptly occurred. Not this time, however. Long-term interest rates have fallen only slightly, and stock prices keep declining. Only the dollar is, belatedly, reacting in normal fashion. But with the whole world economy now in the doldrums, U.S. exports are sure to fall despite a lower dollar. All in all, it can be argued that overall financial conditions have tightened in the United States, despite the Fed's drastic easing.

Profits are in a free fall. Business capital spending is in its steepest plunge in two decades. Numerous corporate executives express unrelenting pessimism. And with financial markets so unresponsive to the Fed's rapid rate cuts, from where, then, can the economy's recovery possibly come? The almost unanimous answer is: from a consumer who increases his spending regardless of what happens to corporate America.

Frankly speaking, it shocks and frightens us to read and hear from all sides that in this precarious global situation the debt-laden consumer is now the U.S. economy's crucially important backbone. This certainly makes for a very different new paradigm economy. For us, this is a thoroughly absurd idea simply because falling production is cutting down the consumer's income. Under these conditions, ever more borrowing is needed to finance higher consumer spending. We are unable to consider this a feasible proposition for the U.S. economy.

## DOUBLE BUBBLE

Meanwhile, what has been keeping the consumer in his high spending spirit is common knowledge. It is another bubble, a house price bubble, and easy facilities to raise cash and substantially higher credit through massive tapping of mortgage refinancing. *Inside Mortgage Finance* estimates that a record $500 billion of 1-4 family mortgages were originated during the last three months, exceeding last year's level by almost 400%. In this respect, the Fed's easing has obviously been highly effective; indeed, far too effective. The new housing boom is another rapidly inflating asset bubble financed by the same loose money practices that fueled the stock market bubble.

But where is all the money going? A relatively small part went into the purchases of goods and services, adding thus to GDP growth. By far the greater part, though, apparently went back into the housing market, showing in particular in accelerating house price inflation. While stock prices are sharply down since the start of 2001, average house prices are rising at an annual rate of 8%. In many areas, however, they are up well in the double-digits. As all this is happening at record-high levels of turnover of old and new houses, it seems appropriate to speak of a new bubble. Robert J. Shiller, author of *Irrational Exuberance*, warns that a psychological frenzy not unlike tech mania is gripping housing.

Only a desperate person can regard this as a sound development. Mr. Greenspan *is* desperate.

After his congressional testimony on July 24, a Senator asked him about home equity. *"This has been a good thing for the American economy and temporarily helpful in addressing the consumer issue and the current sluggishness," he said. "My question to you is, since it has historically been a significant percentage of household savings, is this a worrisome long-term trend, people drawing down their home equity substantially?"*

**Chairman Greenspan:** ***"If unrealized capital gains were declining, which is, of course, what happens when you extract equity from homes, yes, it would be a problem. But there is no evidence of that. Indeed,***

***despite the fact of the significant extraction of home equity gains, the level of unrealized capital gains continues to rise apace. So it's not a depleting asset, if I may put it that way. It could be, but fortunately it is not."***

In other words, Mr. Greenspan hopes that a new bubble, the housing price bubble, is coming to the rescue of the consumer and the U.S. economy. We are not sure what perplexes us more: The fact that the world's leading central banker expresses such a view, or the fact that he can do so without any protest. We think one reason for this is that everybody is desperate.

## WALL STREET MODEL IN COLLAPSE

Tracking the public discussion about the U.S. economy's downturn, it strikes us how little attention the profits and capital spending collapse attracts compared to the general obsession with the question of what the consumer does. We realize this approach is a tradition in the United Stated dating back to the 1920s. A more apparent reason seems to be that consumer spending accounts for about 70% of GDP growth, as against only 12% for business capital spending. In the same vein, Mr. Greenspan worries mainly that consumer confidence may erode the chances of recovery.

We have always regarded this traditional emphasis of the American consensus on consumer spending as lousy economics. Consumer incomes essentially derive from production. Therefore, it has to be asked in the first place: What determines the growth of production? The short answer is: profit prospects that stimulate business capital spending. Profits are the key driver of capital investment, and rising capital investment is the key ingredient in the economy that provides for everything else that we want: growth in output, in incomes, in productivity, and in overall national wealth and prosperity figuring in the economy's accumulated stock of income-yielding tangible assets. Capital investment, in short, is paramount. It happens that it is the great neglect in the Wall Street model, which instead places shareholder value on a pedestal.

***It ought to be realized that mergers, acquisitions, downsizing and restructuring have nothing in common with capital spending and capital formation. Rather, their influence on new capital spending can only be negative. It's mainly for this reason that we have always rigorously refused to acknowledge Wall Street's new-fangled growth mode with its emphasis on shareholder value, innovation, productivity growth and consumer borrowing. This thinking is typical of people who believe they can have everything for nothing.***

Focusing too much on still-resilient consumer spending and far too little on the collapse in profits and business capital spending, most economists are at a complete loss to comprehend the severity of the economic situation in the United States. As profits keep falling precipitately, the outlook is for more cuts in capital spending. Business spending on factories, buildings and other structures, which had grown an inflation-adjusted 12% in the prior 12 months, shrank at an 11% annual rate.

Appreciating the extraordinary vehemence of the slide in business capital spending, the widespread hopes for rescue from the threatening recession by the consumer appear utterly naïve. First of all, the consumer himself is grossly indebted, and with sharply slowing income growth, this will soon begin to hurt him. And the second inhibition concerning his ability to revive economic growth arises from the type of spending that he does. Different types of spending have very different secondary multiplier effects on the economy. "Heavy" capital expenditures involving a massive input of material has a big effect, while consumer spending on services has the smallest effects. Bear in mind that around one half of consumer spending is on services.

Another strange streak in the discussion about the U.S. economy's prospects is the great emphasis accorded to sustained, high productivity growth. What's the relevance of sustained productivity growth in a recession? It recently made headlines and caused jubilant comments when the Commerce Department reported annualized productivity growth of 2.5% for the second quarter of 2001. Commentators hailed it as proof that the "New

Economy is real." We would say that it primarily reflected a sacking of labor, rather than the New Economy. Besides, a substantial downward revision of GDP growth in that quarter is already in the cards.

## DOLLAR TROUBLE

Finally, we are coming to the one question that we regard as the most important of all: the fate of the dollar. Is there hope for a gradual, orderly correction doing no serious harm to the U.S. bond and stock market? Alternatively, is there a serious risk of a free fall? With past steep declines in the stock market, a stagnant economy and a still bulging trade deficit, one wonders why foreign investors continue their large-scale buying of dollar assets, rather than stampeding for the exits. The dollar's turnaround has accelerated ever since the Federal Reserve Beige Book, a summary of business conditions compiled from anecdotal evidence supplied to the 12 regional banks, was published in early August. This report suggested the manufacturing recession was spreading throughout the economy. After peaking on July 4, the dollar has since lost around 10% against the euro.

While this represents a pretty sharp decline in such a short period, it has caused remarkably little concern about a possible steeper fall of the dollar. A recent poll of 250 economists from the leading banks around the world elicited a consensus average of 0.932 for the dollar against the euro by end-August 2002. The most optimistic was a forecast of parity between the two currencies.

There is, clearly, no aggressive dollar selling. And while it seems that the number of dollar bears is growing, fears of a still possible recovery of the U.S. economy are apparently holding them back from acting. Clearly, dollar strength or dollar weakness now hinge crucially on the outcome of whether or not the predicted and generally expected U.S. economic recovery will materialize. Once that fear vanishes, the dollar will come under massive attack.

Our own reflections about the dollar start with the assumption that two things above all make it extremely vulnerable to any change in sentiment about its future strength. The one is the accumulated, astronomic U.S. foreign indebtedness that is running into trillions of dollars and is still soaring. And the other one is the grossly inflated expectations about miraculous "new era" rates of return on U.S. assets, assuring also a permanently strong dollar. It is another cause of great amazement to us how little attention this accumulated foreign indebtedness finds, perhaps in the view that all this belongs to the past. We are convinced that the past will catch up with the dollar, once the rude awakening from the new paradigm illusions begins in earnest. Let us start with a look at the numbers (see table).

**U.S. INTERNATIONAL INVESTMENT POSITION**

| | 1998 | 1999 (Billions of dollars) | 2000 |
|---|---|---|---|
| **Net position** | | | |
| **At current cost** | -1,128.7 | -1,099.8 | -1,842.7 |
| **At market value** | -1,424.0 | -1,525.3 | -2,187.4 |
| **U.S.-owned assets abroad** | | | |
| **At current cost** | 5,091.6 | 5,921.1 | 6,167.2 |
| **At market value** | 6,063.2 | 7,206.3 | 7,189.8 |
| **Foreign-owned U.S. assets** | | | |
| **At current cost** | 6,220.3 | 7,020.9 | 8,009.9 |
| **At market value** | 7,487.2 | 8,731.7 | 9,377.2 |

*Source: Department of Commerce, Survey of Current Business, July 2001*

Foreigners, in particular Europeans, are big players in U.S. stocks, Treasury bonds and corporate and agency bonds. Recent data show that capital flows into the United States — the mainstay of the strong dollar — have substantially deteriorated. Besides, they have shifted away from direct investment in the form of mergers and acquisitions to more mercurial investments in stocks and, particularly, in corporate and agency bonds. Factor in that the United States needs close to $3 billion of new capital every working day from abroad to finance both its current account deficit and its own capital exports (Paul Volcker).

In actual fact, not just the financing of the current account is at risk. Immeasurable risks loom equally in the total stock of dollar assets held by foreigners. They, too, can largely be yanked out at a moment's notice. Given the past dollar euphoria, it appears manifest that these astronomic foreign holdings of dollar assets are in total not hedged against a dollar depreciation. Assuming even a continuous, great reluctance of these dollar bulls to liquidate their positions, even a modest change in investor sentiment can have devastating effects. All the dollar needs to be sent reeling are two things: sharply lower, foreign new purchases of dollar assets and some hedging of the huge, existing dollar positions.

Europe, in contrast, has every reason to be cheerful about a weaker dollar. The possible harm to exports to the dollar area is vastly outweighed by the benefits that accrue in many ways to the euro-zone's economy as a whole. Import prices, particularly of oil and commodities that are quoted and traded in dollars, will drop. Lower inflation will boost real incomes of consumers and lower costs of businesses, and will also give the European Central Bank ample scope to reduce interest rates. The net result will be a boost to domestic demand.

We have always argued that the falling euro, through its pervasive, negative effects on domestic purchasing power, was crucially responsible for the euro-zone economy's weakness. Broadly speaking, strong currencies make for strong growth and strong financial markets, while weak currencies make for the opposite.

Yet there is a great threat to Europe in the U.S. development. Only it will not operate through the trade balance but through the capital account. Continental Europe's primary concern ought to be the potential devastating effect of a free-falling dollar on the value of accumulated dollar assets, both on balance sheets and on confidence. Europe, after all, accounts for two-thirds of total private holdings of U.S. stocks and bonds. And please consider that they will lose twice: on the value of the dollar and on the value of their assets. In the United States there is a wealth disaster for Europe in the making.

## CONCLUSIONS:

Wall Street, Greenspan & Co. have very successfully sold worldwide the idea that the U.S. economy, propelled by the technological and managerial revolution, would in the long run expand at a considerably faster pace than Europe, offering far superior rates of return. In ready response, uncritical European corporate and fund managers stampeded into U.S. stocks in the persuasion of buying a ticket for miraculous growth and rates of return. What most of them actually bought was a ticket for financial disaster.

It is our view that the U.S. dollar and U.S. financial assets, both stocks and bonds, are destined for a dramatic plunge. It is inevitable for three reasons: the mammoth current trade deficit, the mammoth foreign indebtedness and the impending final burst of the New Economy fantasies.

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